Managing Deeper Integration in Asia and the Pacific

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Introduction

In1994 APEC produced one of the most significant initiatives of free and open trade and investment in the region. Since then, thanks to progressive trade and investment liberalization, East Asia has become a more open economic region. Goods, services, and to a certain extent, factors move freely among countries in the region. The gradual removal of border measure has brought economic benefits as testified by rapid economic growth in the region.

However, further welfare gains can be realized if further structural impediment, i.e. beyond and across border measure, are relaxed. Realizing this, in November 2004, the APEC leaders reaffirm their commitment to promote structural reform and their determination to demonstrate leadership to strengthen implementation of structural reform in the APEC region.

The purpose of this paper is to examine the challenges of deeper integration in Asia and the Pacific and strategies for institutional and regulatory reform the objective of which is to make markets in the region more contestable and competitive. The focus is on structural reform beyond-the-border and managing the domestic politics of structural reform and how regional arrangements might be directed to assisting structural

Benefits of Reform

APEC commitment implies recognition of the benefits of competition that underlies the workings of a market economy. It is often argued that a more contestable and competitive market reduces the price distortions and encourages economic agents to improve productivity so as to provide goods and services with a cheaper price and better quality and wider choice for consumers. Central to the effort to make market more competitive is the idea that the benefits of competition will only emerge if economic agents are allowed to freely enter into and exit out economic activities according to the incentives they face. A particular attention should be given to the free movement of good and service across border.

There are several other benefits that are rarely mentioned in discussions about the competition. First, competition and decentralized decision-making can make an economy more flexible and robust in the face of external shocks. Producers who must compete in competitive markets and have to predict their immediate circumstance on a daily basis will be better prepared to react to changing global market conditions than producers in a monopoly market or producers who are protected by government. Second, competition will contribute to the elimination of corruption because competition makes the private sector and the relationship between ruler and entrepreneurs to become more transparent and accountable. Third, competition can reduce the government budget that is used by state and regulatory purposes so that the government budget can be more directed to poverty alleviation.

In the theoretical IO and trade literature, it is often argued that participation in export activities may be beneficial to a country because of increased productivity through reallocation of resources from inefficient firms to more efficient firms. In addition to conventional efficiency benefit of trade, Corden (1997), for example, shows the potential of spillover benefits of trade. First, the presence of imported goods in domestic markets shows domestic producers there is a market for the products. Second, the imported goods carry technical knowledge with them, enabling local producers to copy the goods. It also shows domestic import competing producers what it is possible to produce. Import competing producers may have a cost advantage in this regard since the greatest cost of research might be the cost of finding out which problems are soluble.

In a more recent literature, Sethupathy (2007) argue that efficiency benefit may be magnified if we can find the existence of productivity spillovers from exporting. argued that there are three channels for export spillover. First, under economies of agglomeration, the knowledge accumulated from learning by exporting could easily spillover to other firms in the same industry (horizontal spillovers). Second, a highly competitive international market forced the exporting firms to use higher quality inputs. This could result in exporting firms sharing knowledge and technology with their upstream partners in order to improve the inputs that they receive (upstream spillovers). Finally, the exporting firm's improved productivity could lead to higher quality input for its downstream partners, which in turn could have a positive effect on downstream productivity (downstream spillovers).

Another corollary, foreign competition by allowing foreign direct investment indiscriminately can play important role. According to the standard industrial economics exposition of FDI, profit maximizing foreign firms must possess certain competitive advantages to overcome the intrinsic costs associated with 'being foreign'. There is a widespread consensus in the literature concerning these factors, at least in abstract formulation. Caves (1974) focused on four general sets of factors, the most important of which was intangible capital - foreign firms possess a range of intangible assets deriving from an ability to differentiate their products, from a superior technological base, or from a capacity to circumvent absolute size as a barrier to new firm entrants.

About 95% of the world's R&D expenditure occurs in OECD countries, which are still the headquarters of most major MNCs. Multinationals undertake more R&D than their domestic competitors, particularly in developing countries, and are able to draw on a stronger technological base in their home country. Therefore, foreign firms are likely to have a disproportionate presence in technology-intensive activities, characterised by above average R&D expenditure. In other words, foreign firms tend to cluster near the best practice frontier.

In short, FDIs are distinguishable from local firms because the proprietary technology that FDIs owned allows them to compete successfully with local firms. Moreover, the entry of foreign firms disturbs market equilibrium and forces local firms to take action to protect their market share and profits. Those two factors may create various externalities that benefit local firms. The channel through which these externalities spillover to domestic firms are: increased competition, labor turnover, or through demonstration.

Finally, the third aspect that has an indirect effect on market performance is the presence of SOE. State owned enterprises tend to operate under soft budget constraints. Under soft budget constraints, state owned enterprises are less likely to face bankruptcy. SOEs are under much less pressure to adjust production to changes in external conditions. Since the government tend to be ready to intervene if the enterprise runs into problems by various means that my distort markets, for example, by increasing the centrally stipulated prices, by awarding special loans or grants, or by renouncing demands for payment of taxes.

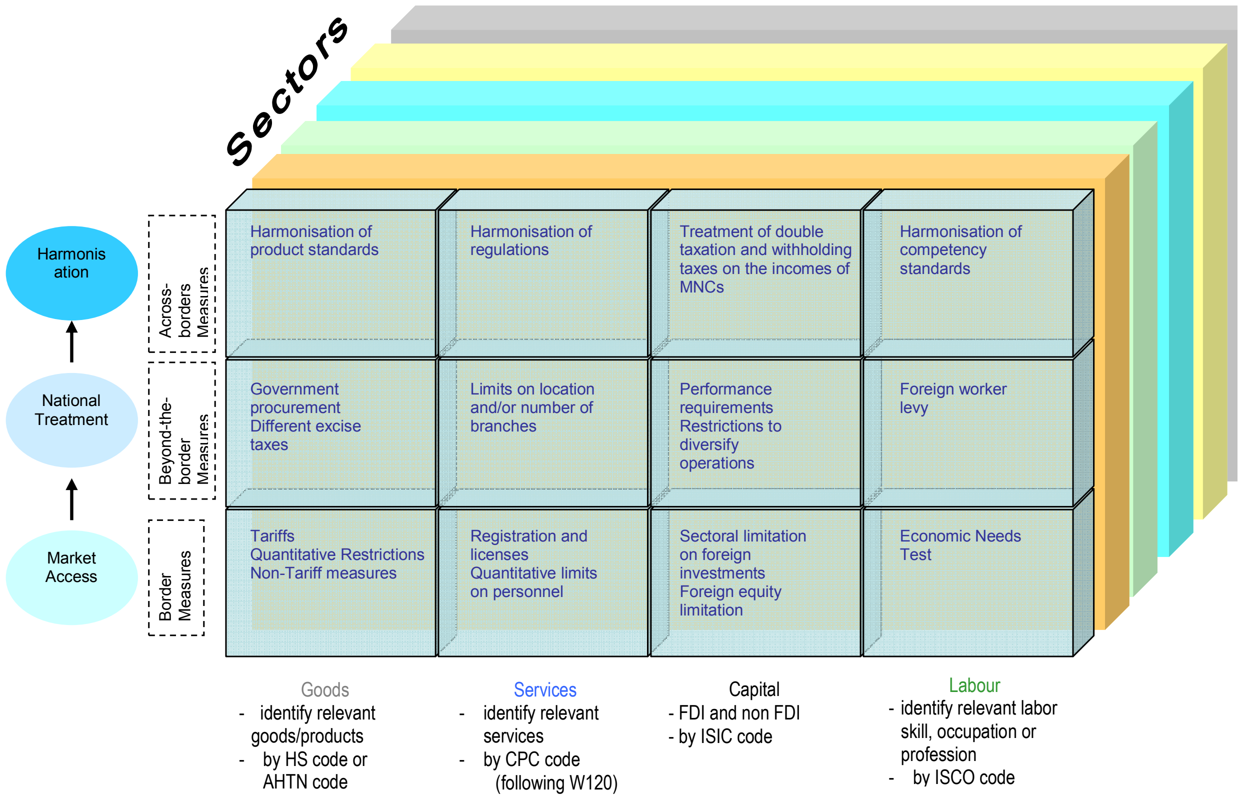
With a remote possibility of bankruptcy, managers of SOE have a large leeway to indulge in satisficing behaviour. Moreover, the satisficing behaviour of SOE managers cannot be checked due to the monitoring problems inherent in public ownership. The fact that public ownership is diffused among all members of society, and no member has the right to sell his share, gives little economic incentive for any owner to monitor the behaviour of firm management (Alchian, 1965). Given these aspects of public ownership, it is often argued that public ownership is inherently less efficient. The problems are compounded if the government has objectives other than profit motives. In Indonesia, government often imposes socio-political objectives on state enterprises, and when financial performance is poor, the social objectives are advanced as an excuse.

Gradual Reform Process

Previous discussion has stressed the importance of eliminating barrier in the movement of goods and services in order to achieve a more competitive and contestable market. In a regional context, it involves the removal of measures which discriminate against foreign suppliers of goods and providers of services and suppliers of factors. In other words, the reform is meant to produce a more integrated region, in which goods, factors, and services move freely among nations in the region.

Figure 1 provides summary of measures that may affect the movement of goods, services and factors. Economic integration implies removing or of adjusting border measures, beyond border measures, and across border measures in order that goods, services, capital and labor can move freely among countries. It also implies that measures which discriminate against foreign suppliers of goods and providers of services and suppliers of factors are removed.

Figure 1: Border, Beyond Border, and Across Border Measures



Source: Adapted from: An Investigation into the Measures Affecting the Integration of ASEAN's Priority Sectors. Phase I: Concepts & Methodologies

Soesastro (forthcoming) shows that the process of integration in East Asia is undertaken in stages. The so called "first generation" of reform removed border restrictions. Initially, East Asian countries used measures other than trade liberalization to promote exports. This was followed by trade liberalization. Subsequently, the East Asian economies, the ASEAN economies in particular, embarked on investment liberalization. Soesastro argue that the initiative was driven by the idea of forming the global production platform for the global markets.

Increasingly, it has been realized that removal of border measures is not enough to ensure free movements of goods, services and factors. The second generation of reform deals with *beyond-the-border* measures. The removal of beyond-the-border restrictions are usually known as the principle of National Treatment, the rule that a good or factor that crosses the border should receive the same treatment as a like product produced domestically or a like factor with respect to taxes and charges and regulations.

Finally, implementation of National Treatment is not enough to remove all measures which inhibit cross-border movement of goods, services and factors. For example, in some cases, there is no violation of national treatments yet the barrier to trade and investment exist. This occur especially the case for standards for industrial products, the environment and other areas. They are not always discriminatory since the measures apply equally to domestic and imported goods. However, to meet these standards foreign producers have to modify their products. In the similar fashion, differences in business laws among countries in the region may inhibit the movement of goods, services, and factors. In this case, harmonization of business law may be required.

Political Economy of Reforms

Even though the gains of structural reforms can be significant for the domestic economy as well as for the regional economy, removing these structural barriers is generally found to be difficult due to complex political economy factors. Therefore it is important to assess the political economic reasons why good structural reforms are not adopted. Dee (forthcoming) provides the analysis for the question:

- Governments do not know what is policy 'best' or 'better' practice, or lack the capacity to implement it. This argues for external assistance to governments to provide the expertise to undertake systematic reviews of existing policy arrangements, and to evaluate policy alternatives. It also argues for external assistance to build the capacity to implement better policies. Finally, it argues for an international exchange of policy experience to raise awareness of what constitutes better practice, and how to implement it. The APEC regional processes have been highly effective in providing a forum for such exchanges of policy experience to date.

- Governments know what 'better' practice is, but face political resistance from vested interests. This argues for government-sponsored policy reviews to analyse the gains and losses to all players, not just the vested interests, so as to help marshal countervailing interests in favor of reform. It also argues for an international exchange of experience about how to handle vested interests, and how to strengthen domestic institutions in favor of the public interest.
- Governments do not want 'better' policy, because they rely on the rents from current policies for political funding purposes. In these circumstances, government itself is a vested interest, and will be resistant to initiating its own policy reviews that would expose the costs to others of current policies. However, there is a potential role for private (or otherwise independent) policy review institutions to carry out the necessary work of scrutiny, and to marshal countervailing interests in favor of reform.

To these reasons we can added a fourth.

- Governments know the best practice and want a good policy but do not have enough resources, capacity and/or authority to implement reforms.

The above taxonomy treats government as a single entity. However, it is useful to distinguish different actors, within government such as the president, coordinating ministries, technical ministries, other independent regulatory bodies, and parliament. Similarly, it is also useful to expand the framework to include actors outside the government that are involved in the policy making/implementation process. These includes among others: incumbent producers, potential new entrants, and upstream and downstream industries (Dee, forthcoming).

Coordination problems occur when the actions of one actor affect the outcomes of other actors. Paradoxically, if each actor maximizes their own payoff, the resulting aggregate social outcome may be sub-optimal. This is known as a prisoners' dilemma. The prisoners' dilemma can be solved (and hence the social optimum achieved) if there is an enforcement mechanism, either through external authority or internalized rule, that punishes those who defect and rewards those who cooperate. Therefore, it is important to highlight the different degrees of authority or power attached to each actor in the policy making process. With this framework in mind, we can combine the two variables: (a) the reasons why a good policy has not been implemented; and (b) the actors involved in the policy making process, into a consolidated matrix presented in Table 1.The table, hence, provides a summary of these actors, their influence and their objectives.

Table 1: Major economic policy actors, their influence and objectives

Actor	Analytical Expertise	Rents from Poor Policies	Authority/influence
Economics Ministries	High/Low	High/Low	High/Low
Line/technical Ministries	High/Low	High/Low	High/Low
Local Govts	High/Low	High/Low	High/Low
Parliament	High/Low	High/Low	High/Low
Academics, Think Tanks	High/Low	High/Low	High/Low
Vested Interests	High/Low	High/Low	High/Low
Media, Civil Society	High/Low	High/Low	High/Low

Applying the framework in the Indonesian political economic setting, for example, may shed light on the difficulty facing policy makers in implementing the reform. The core economics ministries (together with the central bank) have high levels of analytical expertise, their mandate and objective is sound economic policy, but they have limited influence outside of macroeconomic policy. With the exception of a small number of academic think tanks, no other policy actor in the system has a similar combination of expertise and objectives. Most of the other players have limited analytical capacity, moderate to high influence over policy, and an objective function dominated by narrow sectional interests, firm, sector, project, or region-specific.

Table 2: Major economic policy actors, their influence and objectives: Indonesia

Actor	Analytical Expertise	Rents from Poor Policies	Authority/influence
Economics Ministries	High	Low	Limited outside macroeconomics
Line/technical Ministries	Weak, apart from sector-specific knowledge	High	Generally high
Local Govts	Generally weak	Potentially high	High
Parliament	Generally weak	High	High
Academics, Think Tanks	Variable; some high	Low	Moderate
Vested Interests	Weak, apart from sector-specific knowledge	High	Moderate, variable
Media, Civil Society	Generally weak	Variable	High

As a consequence, policy review and policy making processes are generally long and uncertain, with the significant possibility of poor outcomes. This flows from the constellation of actors identified in Table 2, in particular the activist parliament. Moreover, implementation of policy, once decided, is often unpredictable, as a result of this fragmented power and conflicts among the actors.

This general framework can contribute in assessing the policy review process which, eventually, may lead to a better policy options. For example, if the problem is that the governments do not know what is policy ‘best’ or ‘better’ practice, then the policy reviews can help to map the current policy performance, and identify better options. Basically the process involves three step analyses: Identification-Verification-Impact Assessment. Various methods that have been developed can be utilized for this purpose. These include:

- Performance Index
- Checklist approach
- Growth diagnostic approach
- Regulatory Impact Analysis

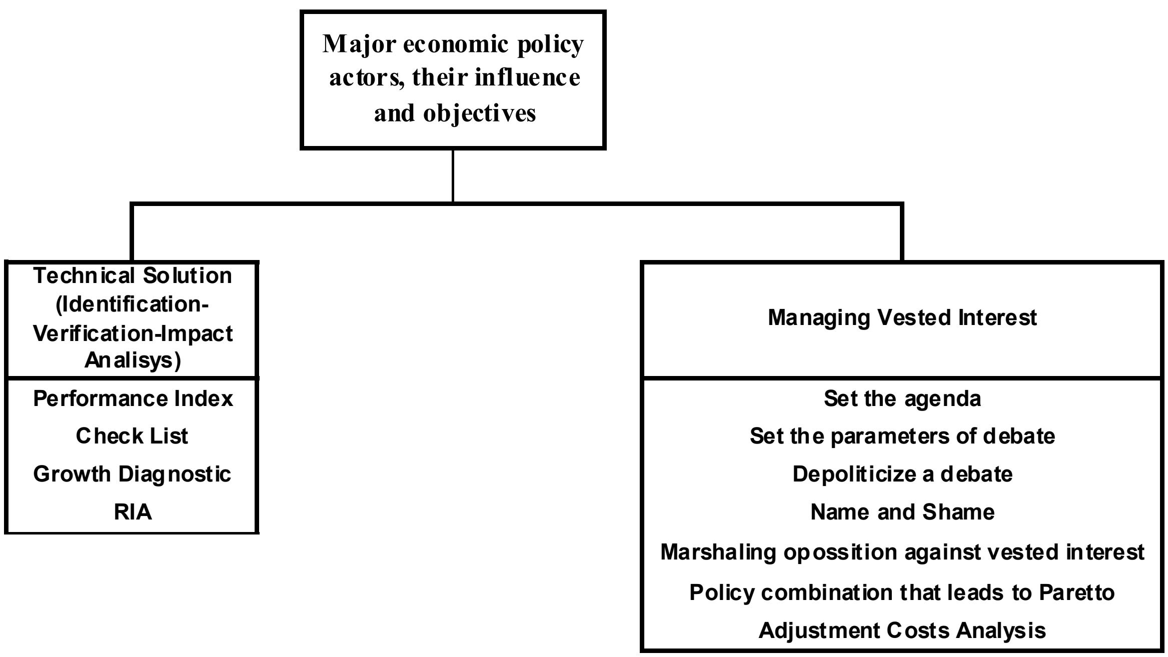
However, if the problem is managing vested interest in fragmented political economic setting, like in the case of Indonesia, then the policy reviews are a strategy rather than a technical solution. Dee (forthcoming) shows how policy review process can help deal with vested interest: (i) policy review can set the agenda (ii) policy review can set the parameters of debate (iii) policy review can help to depoliticize a debate (iv) policy review can “name and shame” the recipients of special deals (v) policy review can marshal countervailing interest against vested interest (vi) policy review can help to identify policy combinations that lead to Pareto improvement.

Beyond policy review process, managing vested interest during structural reform is usually couched in terms of adjustment costs associated with the process of transition. Understanding adjustment costs may help developing countries to implement structural reform with minimal social disruption. Adjustment costs analysis may also shed light on the question why some groups might reject structural reforms. First, the costs of reform tend to be upfront and are concentrated on particular groups who oppose the reform (mainly small numbers of producers), whereas benefits tend to be more diffuse (mainly consumers) and emerge overtime (Olson, 1965). Second, potential beneficiaries from reform tend to be widely dispersed, poorly informed about the trade-offs and possible benefits, and hence uncertain about who gain from structural reforms. Third, bureaucratic structures are typically aligned with particular sections of the economy or community. Fourth, multiple jurisdictions increase the difficulty of achieving nationally consistent approaches.

The adjustment costs analysis becomes even more relevant to developing countries for two reasons. First: developing countries typically have less resources and safety nets in place to adequately deal with adjustment costs. Second, the distribution mechanism, to deal with adjustment costs of reform tends to be inadequate.

Finally, the three analytical frameworks above: (i) mapping the actors, influence, and objectives (ii) technical solution and (iii) adjustment costs analysis, can be combined into a single framework:

Figure 2: Review Processes: Technical Solution and Managing Vested Interest



Role of APEC

How cooperation among countries evolves remains a challenging issue across disciplines. Two models have attracted most attention: the prisoner's dilemma for pair wise interactions and the public goods game for group interactions. Understanding the logic behind this cooperation game may shed light on the role of APEC in helping member country to advance the structural reform agenda.

It has been discussed previously how coordination problem may prevent policymakers in producing good policy. Prisoner dilemma occurs in a strategic situation when the actions of one actor affect the outcomes of other actors. The paradox is, if each actor maximizes their own payoff, the resulting aggregate social outcome may be sub-optimal. The prisoners' dilemma can be solved (and hence the social optimum achieved) if there is an enforcement mechanism, either through external authority or internalized rule, that punishes those who defect and rewards those who cooperate.

However, enforcement mechanism through external authority is a process fraught with political sensitivity and difficulty, and can be counter-productive in its effect. This is the dilemma face by any regional cooperation in advancing domestic reform process, the choice between voluntary or binding type mechanisms. On the one hand voluntary type is riddled with free rider problems common in prisoner dilemma situation; on the other hand binding type is fraught with political sensitivity.

Recent literature on information economics, game theory and behavior economics may suggests a possible way out from the free rider problem discussed previously. Hayek (1945) shows that information sharing, through price signal, as the chief feature of efficiency in competitive market. Hurwicz (1973), took Hayek's idea further and developed mechanism design theory. Spence (1974) developed signaling game in which one party take costly actions in order to convey some meaningful information about itself to another party. Rabin (1996) suggests that "most information sharing is not done through Spence-style signaling, through the price system, nor through carefully crafted Hurwicz-style incentive-compatible mechanism: it is done through ordinary, informal talk." Rabin suggests that cheap talk - a talk that does not directly affect payoffs but may affects people beliefs, and hence affect payoffs indirectly - can often does matter, but it does not generally lead to efficiency.

How the voluntary nature of APEC may help in advancing structural reforms? The second generations reforms discussed previously deal mainly with beyond border issues. Therefore, they are mostly domestic regulatory issue, not cross border issue. The role of APEC is therefore helping domestic economy in advancing structural reform while avoiding political sensitivity associated with binding type cooperation. Drysdale (forthcoming) suggest that APEC start with setting out some principles that are critical to success in regional cooperation. The starting principle is that regional structural reforms need to be tailored to the particular circumstances and needs of each economy. He classifies the particular circumstances and needs of each economy similar to that of figure 2: those that need technical solutions assistance and those that need assistance in managing vested interest. Soesastro (forthcoming) suggests three strategies to support microeconomic reforms in its member economies: (i) an arrangement to produce independent analysis with transparency in reporting and discussion of results (ii) delivery mechanisms to assist in the enhancement of capacity of member economies for policy development and implementation; and (iii) follow-through mechanism to ensure implementation of commitments by member economies.

Possible Application of APEC Review Process

APEC can apply review process to a country, a particular sector, or a particular theme/problem (see Figure 1). One possible area that APEC can focus on is infrastructure and logistic for the following reason: (i) infrastructure and logistic is a key factor in economic development (ii) infrastructure and logistic also help in narrowing gap between developed and backward region (iii) infrastructure and logistic is crucial for regional cooperation and integration.

APEC needs not start from scratch in implementing the Review Process. The identification phase has been carried out by many regional initiatives. For example, ERIA has produced East Asian Index of Infrastructure Development and Index of Regulatory Restrictions in Logistic Services. On the performance side, World Bank has also produced Logistic Performance Index, which evaluates seven areas of performance: customs, infrastructure, international shipments, logistics competences, tracking and tracing, domestic logistic costs, and timeliness. APEC can continue the study into a more detail analysis.

APEC can use framework depicted in figure 2 to help member country in regulatory reform for infrastructure and logistic service. First, APEC can draw from experts around the region to come up with possible technical solutions for countries that need them. The following illustration may highlight the point: Many good project proposals fail to get funding because of lack of capacity in making project proposal. APEC can help alleviate this constraint by providing training to make a good project proposal. Another example is in the area of bidding process. Given the economies of scale, often it is necessary that infrastructure development is conducted by a monopoly. However, lack of competition may create inefficiencies. It is therefore necessary to introduce competition for the market, not in the market. APEC can help member countries in designing an efficient bidding process that ensure competition for the market. Finally, production and distribution of infrastructure services, such as Telecommunication and Electricity service is a mix of natural-monopoly segment and competitive segment. The competitive segment can be separated from the monopoly part known as unbundling. Australia experience in unbundling its telecommunication services can be shared to other countries in the region. Similarly, the success and failure of Philippine experience in implementing Build-Operate-Transfer to alleviate financial bottleneck can also be shared.

A more difficult task for APEC is to help the member countries in managing vested interest. Many problems that hinder infrastructure development are political economy in nature. One example that is common in the infrastructure sector is pricing issues. The vested interests that benefit from lower price often prevent government to raise user fees for many infrastructure services. APEC may help government in formulating rational policy on user fees of infrastructure services, including mechanism to ensure that all stake holders' views be heard. Other important political economic issues relate to decentralization; a problem that frequently occurs in Indonesia and Philippines. Both countries may share experiences through APEC in managing decentralization especially in the area of infrastructure development.

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